

Brown Forum for Enterprise

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Capital Term Sheets & Valuation

March 22, 2007

Cap Table Planning

Sample Cap Table	Formation	%	Option Pool	%	Series A	%	Series B	%	Pro-rata value
Common Stock	100,000	100%	100,000	77%	100,000	29%	100,000	15%	\$ 2,283,539
Option Pool			30,000	23%	50,000	14%	60,000	9%	\$ 1,370,124
Series A Preferred Stock					195,000	57%	195,000	30%	\$ 4,452,902
Series B Preferred Stock							301,875	46%	\$ 6,893,435
Total	100,000	100%	130,000	100%	345,000	100%	656,875	100%	\$ 15,000,000
Pre-Money valuation					\$2,000,000		\$ 8,000,000		
Price per share	\$0.01		\$0.01		\$ 15.38		\$ 23.19		
Total Investment					\$3,000,000		7,000,000		
Total value of Company	\$1,000.00		\$1,300.00		\$5,000,000		15,000,000		

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Deal Implications and Best Practices

- Venture deal documents will require accurate disclosure of capitalization of the Company
- Auditors will require capitalization table for audit calculations
- Oral arrangements can lead to problems

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Typical Company Representation

- Section 2.2(d) of the Disclosure Schedule sets forth the capitalization of the Company immediately following the Initial Closing including the number of shares of the following: (i) issued and outstanding Common Stock, including, with respect to restricted Common Stock, vesting schedule and repurchase price; (ii) issued stock options, including vesting schedule and exercise price; (iii) stock options not yet issued but reserved for issuance; (iv) each series of Preferred Stock; and (v) warrants or stock purchase rights, if any. Except for (A) the conversion privileges of the Shares to be issued under this Agreement, (B) the rights provided in Section 4 of the Investors' Rights Agreement, and (C) the securities and rights described in Section 2.2(c) of this Agreement and Section 2.2(d) of the Disclosure Schedule, **there are no outstanding options, warrants, rights (including conversion or preemptive rights and rights of first refusal or similar rights) or agreements, orally or in writing, to purchase or acquire from the Company any shares of Common Stock or Series A Preferred Stock, or any securities convertible into or exchangeable for shares of Common Stock or Series A Preferred Stock.** All outstanding shares of the Company's Common Stock and all shares of the Company's Common Stock underlying outstanding options are subject to (i) a right of first refusal in favor of the Company upon any proposed transfer (other than transfers for estate planning purposes); and (ii) a lock-up or market standoff agreement of not less than 180 days following the Company's initial public offering pursuant to a registration statement filed with the Securities and Exchange Commission under the Securities Act.

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Restricted Stock

- Can be voting or non-voting stock
- Can be paid for with cash or promissory note
- 'Reverse' vesting – subject to "risk of forfeiture"
- "83b election" within 30 days of purchase can lead to favorable tax consequences

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Incentive Stock Options (ISOs)

- Issuable only to employees
- Exercise price must equal FMV at time of grant
- Must be issued pursuant to a qualified plan adopted by shareholders
- If all rules met, no taxable event upon exercise of option
- Company does not get a tax deduction
- Capital gains tax at disposition of stock acquired through option

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Non-qualified stock options (“non-quals”)

- Can be issued to employees, consultants, directors
- More flexibility than ISOs with term of option and other limitations
- **Exercise Price must not be below FMV on grant date per 409A**
- Does not require to be issued under qualified plan
- Optionee is taxed upon exercise of option at ordinary income rates on difference between exercise price and FMV at that time
- Company gets a tax deduction and withholding obligations apply
- Capital gains tax at disposition of stock acquired through option

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Vesting of Stock and Options

- Typically 3-4 years
- 1 year “cliff” – 25%
- 3 years – 75% quarterly
- Typically not subject to repurchase at termination
- Performance based vesting also becoming more popular

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409A Overview

- Applies to all plans and arrangements that provide for the deferral of compensation
- Stock Options issued below FMV are considered a “deferred compensation”
- Tax penalties
 - All compensation deferred become includible in gross income for taxable year in which the failure occurs
 - interest
 - additional 20% penalty

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409A Valuation Issues

- Proposed regulations do not define FMV
- Proposed valuation methods:
 - Formal appraisal by independent valuation expert that must meet IRS test of being "reasonable"
 - o value of tangible and intangible assets;
 - o present value of future cash-flows;
 - o comparables
 - o control premiums or discounts for lack of marketability
 - Value must be determined taking into consideration all available information material to value of corporation as of date within 12 months of valuation date

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409A Valuation Issues – Startup Exception

- Valuation must be made reasonably and in good faith and be evidenced by **written report** that takes into account the relevant valuation factors described above;
- The company (and its predecessors) cannot have been in the active conduct of a business for **ten years or more**;
- The company **cannot be public** (i.e., it cannot have any securities that are readily traded on an established securities market);
- At the time of valuation, it cannot reasonably be anticipated that the company will undergo a **change in control or an initial public offering within 12 months after the valuation**.
- The person(s) signing report must have significant knowledge and experience or training in performing similar valuations. They may be employees or directors of the company.

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409A Deal Implications

- Venture deal documents will now often carry a separate representation that Company has complied with 409A
- Sample Provision:
 - [409A. No stock options, stock appreciation rights or other equity-based awards issued or granted by the Company are subject to the requirements of Section 409A of the Code. Each "nonqualified deferred compensation plan" (as such term is defined under Section 409A(d)(1) of the Code and the guidance thereunder) under which the Company makes, is obligated to make or promises to make, payments (each, a "409A Plan") complies in all material respects, in both form and operation, with the requirements of Section 409A of the Code and the guidance thereunder. No payment to be made under any 409A Plan is, or to the knowledge of the Company will be, subject to the penalties of Section 409A(a)(1) of the Code.]^[1]

[1] Some practitioners will prefer to deal with the 409A issues as a diligence item, rather than making the company rep to it. It is in any case important that the issue be surfaced as part of the financing, to ensure that the company is mindful of the obligations and potential penalties imposed by 409A as it makes future equity grants.

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409A – Recommended Practices

- Award restricted stock
- Avoid common terminology like “founder stock” “cheap stock” etc.
- Recruit team members, board members and advisors with valuation and market experience
- Regular board discussion on option pricing
- Appraisal post Series A level generally recommended
- Appraisal costs range from \$5K to \$15K

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Questions and Answers

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